



Business model sustainability

According to an article published in *Opalesque* last September, hedge funds were approaching an attrition rate of 7% for the full year. A notable pattern amongst falling funds is that the casualties are not only concentrated in the small boutiques segment of the industry but also within the big names. The reasons for closing the funds are however different.

The hedge fund industry commonly uses a fee structure including a management fee calculated as a percentage of AUM and a performance/incentive fee calculated as a percentage of the gains over a previous "high water mark". Both parts of their revenue are affected by the current environment. The poor performance of a large majority of funds this year will have the negative consequence of wiping out the revenue from performance fee until they recoup their losses. Furthermore, funds suffer from a sharp reduction of their assets under management. In October alone, investors pulled \$100 billion according to hedge fund data tracker, *Eurekahedge*.

George Soros said he expects hedge fund industry assets "will shrink by between 50 percent and 75 percent."

Large institutions proposing umbrella of funds are, in the current environment, incentivized to terminate funds that drag firm revenue. They are

likely to focus on funds that will likely earn both management and performance fees.

For smaller assets managers, a negative year for their flag ship fund could simply mean the end of their venture. Those shops usually have not diversified their revenue among several products and the termination of a fund is for them impracticable. However, for those that will decide to stay in business, increasing cost burdens can have some unpredictable consequences; such as for example an increased willingness to take risks in order to keep the business alive and to get back to their high watermark as quickly as possible.

Prudent investors should therefore add a further step to their due diligence by analyzing their manager business plan sustainability.

A recent study by KPMG breaks down the investment manager's costs in the following categories: Front office, business support, corporate control, facilities, infrastructure, IT, marketing and PR and other. According to this study, the largest cost area is facilities, infrastructure and IT

The current crisis is lowering the annual cost of renting, in various popular hedge fund districts, in locations like Mayfair in London and Manhattan in the city of New York. However, the average rent rate in both cities is still around 200 USD

per square foot. A small hedge fund boutique will therefore have to budget around half a million dollar to rent a 2'000 square foot office space per year.

The highest cost, not studied by KPMG, consists of salaries and bonuses. Based on the *Alpha Magazine* 2008 Hedge Fund Compensation study, an investment manager, with assets under \$250ml, composed of a CEO, a CIO, a senior analyst, a senior trader, a COO and a CFO will have to pay in base salaries around \$950'000 per year (based on median figures). Including the bonuses, the total budget for human resources will reach approximately \$2.6ml.

Another expensive cost area is marketing. Small investment managers do not always have an internal team and alternatively hire external third party marketers, which are usually paid between 30% and 50% of the fund's revenue.

Adding all the costs together highlight the precarious situation faced by a lot of fund managers. Those players will also have to face the increasing costs linked to the investors' pressure for better operation infrastructure. According to KPMG, one out of ten fund managers are not currently covering costs by their management fees.

Improving alpha through technology

An investment manager has usually full discretionary authority to direct Fund trades. As a result, the Firm is subject to a duty to obtain best execution for Fund securities transactions. The SEC has described this requirement generally as a duty to execute securities transactions so that a client's total costs or proceeds in each transaction are the most favorable under the circumstances. The SEC has also stated that when seeking best execution an adviser should consider the full range and quality of a broker-dealer's services in placing trades. The SEC has added that the best execution is not determined by the lowest possible commission costs, but by the best qualitative execution. Finally, the SEC has suggested that to ensure continuing compliance with the best execution duty, advisers should periodically and systematically evaluate the execution performance of broker-dealers executing their transactions.

Hedge Fund managers have not yet invested broadly on technology tracking post-trade execution quality. Most of them rely on sample testing of trades.

A recent study by Investment Technology Group, puts in perspective the types of information that can be obtained from the analysis of trades. Execution costs can be split into three categories: Commission costs, timing delay cost and market impact cost.

The commission cost represents the commission rate negotiated by the investment manager with its executing brokers to execute trades. The volume of transactions is determining in the negotiation.

The time delay cost represents any delay cost incurred between the Initial Decision (Open on Day 1) and the Broker Placement Price. Think of this as the cost of Seeking Liquidity.

The market impact cost price change between the time on Order

is Placed with the Broker and the eventual trade price.

According to the study previously mentioned, at the end of Q1 2008, the costs of trading US stocks was 57bp including 7bp commission cost, 16bp impact cost and 34bp delays cost. During the same quarter, the overall cost to trade European stock (ex-UK) was 90bp. The main difference between the two regions was represented by time delay cost, which was 44bp higher in Europe.

Not all the strategies have the same sensitivity to transaction costs. The above mentioned study has revealed that the commission cost represents only a marginal part of the overall transactions costs. In some cases, a detailed analysis of a fund's transactions costs leave room to the optimization of the impact of time delay costs and market impact costs and could improve the bottom line.

Latest Additions to our Library

- Alphagen Capella
- BlackRock European Opportunities
- GLG Alpha Select
- Lazard European Explorer
- MBAM Jandakot
- Sofaer Capital European Hedge Fund
- TT MidCap Europe Long/Short

Register to this monthly newsletter by visiting us at

www.hedgefundappraisal.com

About Us:

Hedge Fund Appraisal is providing due diligence services to hedge fund investors.

- Compensated only by end investors, achieving complete objectivity
- Appraisals offered on pay-per-use basis, no need for a subscription
- Library of readily available reports
- Business model provides us with strong economy of scale and fast service
- Strong expertise; due diligence is our only service
- Better access to information - represent many clients and have award series for operational excellence

For further details, contact us info@hedgefundappraisal.com